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Government Finance

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General Business Conditions

THE wage demands of the steel workers, a cause of concern for months past, have brought the country as this Letter goes to press to the verge of a steel strike, which would disrupt defense production, or alternatively of a rise in steel wages, costs and prices, which would endanger the economic stabilization program. The recommendations of the labor and public members of the Wage Stabilization Board in the steel case, announced March 20, go beyond anything for which the industry or the public was prepared. They call for an increase of 17½c an hour in wage rates, of which 12½c would be retroactive to January 1st and 5c would take effect in two instalments at six months' intervals. To this would be added more holidays and vacation pay, increased shift differentials and other fringe benefits, and establishment of the union shop, which means compulsory union membership for all workers.

The industry members of the Board, who had stood out for lower figures, have stated that these recommendations "would increase direct employment costs by approximately 30 cents per employee-hour". The calculations of the steel companies yield a similar figure. The industry members have further described the increases as "far greater in the aggregate than any increases ever before voluntarily bargained, or recommended, in the steel industry", and declared it "absurd" that "the largest increases in history should be recommended in a dispute case during a period of wage stabilization".

Mr. Charles E. Wilson, who has resigned the office of Director of Defense Mobilization because of disagreement with President Truman's policies in the case, took a grave view of the recommendations from the first. He said: "There is no question in my mind but that, if the wage increases contemplated under the W. S. B.'s recommendations are put into effect, it would be a serious threat in our year-old effort to stabilize the economy. Of that I am sure."

Who Will Bear the Costs?

If the steel companies should accede to these demands, the increased costs must either be absorbed by them or passed on in prices. If not passed on in prices, they would be borne in part by the U.S. Treasury, since reduced earnings would reduce steel company taxes. As a justification of the wage demands, however, this argument is as superficial as it is cynical. Mr. Wilson, whose objective was to bring about agreement and keep steel mill operations going, was firmly of the opinion that the industry could not assume the increases without at least a partially compensating price rise, exceeding the $2 a ton or thereabouts to which the companies are entitled under the Capehart amendment to the Defense Production Act. When he found that he did not have the backing of President Truman and other administration authorities in this, his convictions as to the rightness of his position made his resignation inevitable.

The chances of a strike have been immensely increased by these developments. In view of the

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backing that they have received from the Government, the steel unions are expected to stand on the recommendations. The companies, on the other hand, are already faced with a declining trend in earnings, which for 53 companies in 1951 were 12 per cent lower than in 1950. They are engaged in vast expansion programs, encouraged by the Government. Their working capital position has become less liquid. They need earnings sufficient to induce investment and to maintain their financial strength, both for current borrowing and for the leaner times that will come. In the long run they will suffer if they accept now a burden of labor costs which, even if bearable while capacity operations last, would be intolerable when times change, demand subsides and operations fall off. Demand for steel is already less intense, due to modification of defense schedules, slackness in consumer durable goods and lessened inventory buying, and supply is more abundant due to increased production.

The Public Interest

Whatever the outcome, the public interest is deeply involved. If wage increases of this magnitude are granted to steel workers, other unions in other industries are certain to make new demands to "catch up". Through increased costs, prices and incomes, inflationary pressures will be renewed. But when conditions change, costs and prices will be too high for the market and trade and employment will fall off. Thus the swings both ways will be accentuated.

Finally, the country has a paramount interest in maintaining steel production. What kind of compromise, with or without a strike, may be made is impossible to guess at this writing, but along only one line can a sound solution be found. The wage demands go beyond anything needed to maintain the labor force of the steel industry, which has kept itself fully manned and operating above its rated capacity. They go beyond anything necessary to keep steel wages in fair and equitable relationship to other wages, or to yield steel workers a standard of living comparable with that in equivalent occupations. Since they are excessive according to these standards, it is unrealistic to believe, as some apparently do, that the recommended increases would prove to be the end of a general round of wage increases instead of the beginning of another round. A solution which would hold the steel increases to the point where other unions would feel no compulsion to catch up, and where it could truthfully be said that wage standards were being enforced as rigorously as price standards, would minimize the danger.

Trade and Production Steady

Apart from the steel news, day-to-day business reports during March have been much the same as in previous months. Retail trade is good but not buoyant. Prices of staple commodities have been steadier than in February, but critical materials are easier to get and industrial purchasing agents, like distributors of consumers' goods, are keeping their commitments short. The soft spots in textiles and household equipment, of which so much has been made in recent comment, are still soft. But manufacturers turning out industrial equipment, defense products, and the materials and parts going into them, have huge backlogs of unfilled orders and in many cases are expanding output. A new survey by the Securities and Exchange Commission and the Department of Commerce confirms the expectation that business expenditures on plant and equipment this year will be larger than last.

Industrial production in the aggregate has been rising a little from month to month, and according to the Federal Reserve Board's index is as high as it was a year ago, when post-Korean demands were at their peak. With the conspicuous exception of a few consumers' goods industries, people able and willing to work are fully employed and in some areas workers are scarce.

The increase in allotments of metals for civilian use announced during the month is welcome evidence of the easing of shortages, from which the automobile industry and commercial and public building particularly will benefit. The automobile companies — previously allotted steel for only 930,000 passenger cars in the second quarter, and copper for only 800,000— will now have enough metals to make 1,000,000 cars and will be allowed to turn out 1,050,000 if they can find the additional materials in inventory or by economies in consumption. For the third quarter metal allotments will be enough for 1,050,000 cars. Dealers' stocks of 1952 models are low for this time of year.

Controls over lead and rubber have been liberalized. Zinc may be added to the list. The changes signify that the authorities during the first quarter had drawn the line too tightly. Metal allotments were not fully taken up. In that respect as in others the impact of defense requirements was over-estimated. Now a modest improvement in automobile output and in construction programs becomes possible. The effect on the general situation is helpful, not depressing, even though forward buying is discouraged.

Corporate Earnings in 1951

Annual reports for 1951 that have now been issued by 3,409 corporations show combined net income after taxes of approximately $12.8 billion, which compares with $13.8 billion in 1950 and represents a decline of 7 per cent. This decline is somewhat greater than the 5 per cent shown by our preliminary summary of 2,195 corporations given a month ago. It reflects the less favorable results reported during March by many companies in the manufacturing industries and in retail trade which were hard hit by the forced curtailment of production or the slump in sales of many consumer goods items.

The most widespread characteristic of last year's corporate reports was a gain in the dollar volume of sales, offset by a rise in operating costs and in taxes which caused a narrowing of the net profit margin. While sales and other revenues of all the non-financial corporations in our tabulation aggregating $190 billion were up 15 per cent from 1950, the average net profit margin after taxes was reduced from 7.7 to 6.2 cents per dollar of receipts. Although there were few exceptions among the major industry groups to this squeeze of profit margins, there were numerous cases where net income nevertheless showed an increase because of the great expansion in volume that took place.

Changes by the main divisions of business are shown below, while a more detailed summary by 70 major industry groups is given on the next page.

Net Income of Leading Corporations for the Years 1950 and 1951

(In Millions of Dollars)

No. of Cos.	Industry Divisions	Net Income after Taxes 1950	Net Income after Taxes 1951	Per Cent Change	% Margin on Sales 1950	% Margin on Sales 1951
1,763	Manufacturing	$9,487	$8,711	— 8	7.7	6.2
73	Mining, quarrying	186	199	+ 7	10.3	9.7
197	Trade (ret. & whol.)	716	597	—17	3.8	2.7
258	Transportation	883	821	— 7	7.7	6.4
304	Public utilities	1,335	1,359	+ 2	13.1	11.9
105	Amusements, services	109	106	— 2	5.7	4.5
714	Banks and finance	1,060	1,046	— 1	—	—
3,409	Total	$13,776	$12,839	— 7	7.7	6.2

The decline in net income experienced by a majority of the industry groups meant an even sharper decline in the rate of return on net assets or net worth, inasmuch as these have been added to tremendously in recent years to meet the steadily growing demands for goods and services at inflated prices. Net assets of all corporations whose published figures were available for tabulation totaled $113 billion at book value at the beginning of 1951, upon which the year's net income represented an average return of 11.4 per cent. This compares with net assets of $103 billion at the beginning of 1950 and a return of 13.4 per cent.

These book values at which property assets are carried on the corporate balance sheets are in most cases based upon plant and equipment taken at original costs less accrued depreciation, which are far below replacement costs. Rates of return on actual present-day values would therefore be materially lower than those computed on book values and shown in our detailed summary.

Trends in Manufacturing

Reports now available from 1,763 companies in the manufacturing industries show a decline in net income of 8 per cent for the year. Of the 46 industry groups, 35 showed a decline in net income.

An outstanding exception to the generally downward trend of earnings last year was the group of 91 petroleum producing and refining companies, which on a 17 per cent gain in dollar sales had an increase of 21 per cent in net income. Exclusive of this one important group, the combined net income of all other manufacturing industries in our summary was down 15 per cent.

Income in all lines was cut into sharply by the rise in federal income taxes, which on an average took 58 per cent of all operating earnings in 1951, against 46 per cent in 1950. Such taxes alone represented 8.6 cents out of every dollar of revenue in 1951, against 6.6 cents in 1950. Among individual companies there were wide variations in the impact of such taxes, depending upon the excess profits tax credit and other allowances in each situation.

In addition to the effect of higher taxes which applied generally, earnings of many companies were reduced seriously by such diverse factors as shortages of raw materials and forced curtailment of production on the one hand, or overproduction and accumulation of excessive inventories on the other. Some were caught between a rise in production costs and a fall in selling prices.

For the manufacturing groups as a whole, the average net profit margin after taxes was narrowed from 7.7 cents per sales dollar in 1950 to 6.2 cents in 1951. The average rate of return on net assets declined from 17.1 per cent in 1950 to 14.4 in 1951.

Trends over a period of years in these two measures of earnings may be seen from the following chart based upon our annual tabulations given in the April issues of this Letter.

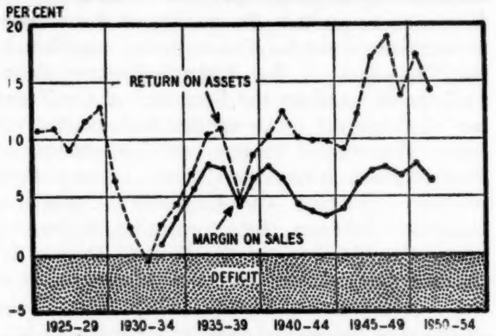
The fact that in recent years the rates of return on net assets have run relatively higher

NET INCOME OF LEADING CORPORATIONS FOR THE YEARS 1950 AND 1951

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Reported Net Income After Taxes 1950	Reported Net Income After Taxes 1951	Per Cent Change†	Book Net Assets Jan. 1 -a 1950	Book Net Assets Jan. 1 -a 1951	% Return on Net Assets -a 1950	% Return on Net Assets -a 1951	% Margin on Sales -b 1950	% Margin on Sales -b 1951
24	Baking	$ 63,912	$ 52,070	—19	$ 402,267	$ 427,320	15.9	12.2	5.0	3.5
15	Dairy products	78,096	64,310	—18	562,161	597,770	13.9	10.8	3.0	2.2
19	Meat packing	52,646	46,634	—11	824,205	852,906	6.4	5.5	0.8	0.6
19	Sugar	50,711	58,866	+16	470,286	487,845	10.8	12.1	5.5	6.2
78	Other food products	265,919	214,017	—20	1,727,238	1,842,071	15.4	11.6	5.1	3.6
13	Soft drinks	42,400	35,947	—15	272,445	283,243	15.6	12.7	11.2	8.7
25	Brewing	42,174	35,348	—16	279,030	298,801	15.1	11.8	6.6	4.7
13	Distilling	148,864	121,009	—19	835,909	937,112	17.8	12.9	6.6	5.0
23	Tobacco products	148,397	118,479	—20	1,179,924	1,210,413	12.6	9.8	5.2	3.9
37	Cotton goods	92,963	92,872	—....	718,950	770,389	12.9	12.1	6.2	5.6
14	Silk and rayon	108,539	70,272	—35	534,665	599,523	20.3	11.7	12.8	9.0
8	Woolen goods	15,252	16,871	+11	192,693	203,534	7.9	8.3	3.9	3.0
19	Hosiery, knitted goods	24,789	16,344	—34	145,544	161,135	17.0	10.1	8.2	5.1
11	Carpets, floor coverings	39,728	11,408	—71	303,983	325,506	13.1	3.5	6.1	1.9
39	Other textile products	115,423	96,655	—16	732,518	802,656	15.8	12.0	6.8	4.9
34	Clothing and apparel	27,655	20,838	—25	260,679	276,749	10.6	7.5	4.2	3.0
30	Shoes, leather, etc.	39,476	32,522	—18	325,271	339,572	12.1	9.6	4.0	3.0
28	Tires, rubber products	163,016	182,956	+12	1,027,786	1,139,017	15.9	16.1	4.9	4.3
25	Lumber	96,033	99,023	+ 3	565,212	625,049	17.0	15.8	9.9	9.7
15	Furniture, wood products	12,836	10,866	—15	68,770	78,407	18.7	13.9	6.8	4.5
86	Paper and allied prod.	320,736	334,217	+ 4	1,878,521	2,073,803	17.1	16.1	10.2	8.3
33	Printing and publishing	41,384	37,184	—10	284,927	301,635	14.5	12.3	5.7	4.6
62	Chemical products	743,574	636,319	—14	3,473,697	3,910,384	21.4	16.3	11.7	9.9
19	Drugs and medicines	99,950	97,749	— 2	456,476	508,609	21.9	19.2	11.3	9.4
18	Soap, cosmetics, etc.	95,143	76,445	—20	455,876	497,999	20.9	15.4	8.5	5.5
19	Paint and varnish	67,188	57,219	—15	393,945	435,792	17.1	13.1	6.4	4.7
91	Petroleum prod. & refining	1,875,150	2,262,028	+21	12,346,685	13,532,439	15.2	16.7	11.2	11.5
27	Cement	57,383	49,333	—14	322,383	350,464	17.8	14.1	15.4	11.8
12	Glass products	128,945	90,732	—30	527,479	593,496	24.4	15.3	10.9	6.8
46	Other stone, clay products	144,831	127,399	—12	784,819	865,022	18.5	14.7	10.8	8.1
53	Iron and steel	784,218	689,379	—12	5,119,588	5,609,589	15.3	12.3	8.1	5.8
10	Agricultural implements	193,246	161,022	—17	1,231,670	1,357,200	15.7	11.9	8.3	5.4
77	Building, heat., plumb. equip.	152,193	128,235	—16	853,219	937,716	17.8	13.7	7.8	5.5
74	Electrical equip., radio & tv.	490,286	403,438	—18	2,180,794	2,495,926	22.5	16.2	7.3	5.2
48	Hardware and tools	56,227	57,567	+ 2	379,529	411,752	14.8	14.0	8.2	6.1
41	Household appliances	101,011	64,079	—37	439,375	491,494	23.0	13.0	7.7	4.9
165	Machinery	221,676	248,439	+12	1,565,315	1,666,649	14.2	14.9	7.6	5.9
29	Office equipment	108,622	106,228	— 2	563,901	630,191	19.3	16.9	9.8	7.4
39	Nonferrous metals	365,534	367,150	+....	2,524,846	2,715,574	14.5	13.5	9.8	8.8
114	Other metal products	223,539	219,795	— 2	1,362,810	1,493,694	16.4	14.7	6.3	5.2
22	Autos and trucks	1,051,043	686,147	—39	3,233,703	3,639,726	32.5	17.5	8.9	5.2
66	Automobile parts	249,510	193,342	—23	1,097,834	1,237,866	22.7	15.6	7.4	4.5
25	Railway equipment	58,560	81,798	+40	791,494	832,906	7.4	9.8	5.5	4.8
29	Aircraft and parts	84,585	57,560	— 32	592,613	649,451	14.3	8.9	4.5	2.2
6	Shipbuilding	D- 451	8,681	+....	95,330	90,298	—0.5	9.6	—1.4	4.0
63	Misc. manufacturing	144,167	122,343	—15	943,975	1,023,289	15.3	11.9	9.0	6.3
1,763	Total manufacturing	9,487,129	8,711,135	— 8	55,330,335	60,616,982	17.1	14.4	7.7	6.2
31	Coal mining -c	62,032	62,388	+ 1	711,638	702,679	8.7	8.9	5.9	5.5
31	Metal mining -c	82,493	96,249	+17	559,402	632,615	14.7	15.2	12.2	13.2
11	Other mining, quarrying -c	41,052	40,187	— 2	137,695	155,739	29.8	25.8	26.6	24.0
73	Total mining, quarrying	185,577	198,824	+ 7	1,408,735	1,491,033	13.2	13.3	10.3	9.7
23	Chains—food	74,772	58,254	—22	431,461	496,761	17.3	11.7	1.7	1.1
55	Chain stores—variety, etc.	152,664	130,845	—14	1,143,704	1,212,965	13.3	10.8	4.8	3.7
52	Department and specialty	174,710	140,720	—19	1,334,641	1,432,497	13.1	9.8	3.6	2.7
7	Mail order	223,970	171,682	—23	1,170,085	1,299,452	19.1	13.2	5.7	4.2
60	Wholesale & miscellaneous	89,835	95,532	+ 6	689.421	735,044	13.0	13.0	2.9	2.5
197	Total trade	715,951	597,033	—17	4,769,312	5,176,719	15.0	11.5	3.8	2.7
131	Class 1 railroads -d	783,284	693,057	—12	13,923,456	14,439,447	5.6	4.8	8.3	6.7
37	Traction and bus	13,200	18,607	+41	486,918	493,223	2.7	3.8	1.5	2.5
15	Shipping	24,210	33,503	+38	345,610	356,755	7.0	9.4	6.9	7.5
21	Air transport	39,387	54,608	+39	316,026	346,849	12.5	15.7	4.9	5.6
49	Misc. transportation	22,619	21,139	— 7	258,443	267,350	8.8	7.9	7.7	6.7
253	Total transportation	882,700	820,914	— 7	15,330,453	15,903,624	5.8	5.2	7.7	6.4
244	Electric power, gas, etc. -d	943,718	952,949	+ 1	9,537,733	10,610,035	9.9	9.0	14.6	13.1
60	Telephone and telegraph -d	391,277	406,013	+ 4	3,943,412	4,547,204	9.9	8.9	10.7	9.9
304	Total public utilities	1,334,995	1,358,962	+ 2	13,481,145	15,157,239	9.9	9.0	13.1	11.9
16	Amusements	32,023	30,209	— 6	486,684	488,821	6.6	6.2	4.9	4.3
39	Restaurant and hotel	12,238	9,683	—21	130.280	135,440	9.4	7.1	4.4	3.3
31	Other business services	44,388	47,523	+ 7	299,023	320,271	14.8	14.8	8.5	6.6
19	Construction	20,328	18,857	— 7	130,750	142,428	15.5	13.2	4.1	2.3
105	Total amusements, services, etc.	108,977	106,272	— 2	1,046,737	1,086,960	10.4	9.8	5.7	4.5
304	Commercial banks -e	501,642	510,421	+ 2	5,979,856	6,352,932	8.4	8.0	—	—
66	Fire & casualty insurance -e	143,630	120,383	—16	1,818,278	2,103,530	7.9	5.7	—	—
181	Investment companies -e	252,936	250,731	— 1	3,062,219	3,654,897	8.3	6.9	—	—
66	Sales finance companies	139,972	144,878	+ 4	759,113	888,470	18.4	16.3	—	—
97	Real estate companies	22,012	19,396	—12	199,897	212,173	11.0	9.1	—	—
714	Total finance	1,060,192	1,045,809	— 1	11,819,363	13,212,002	9.0	7.9	—	—
3,409	Grand total	$13,775,521	$12,838,949	— 7	$103,186,080	$112,644,559	13.4	11.4	7.7	6.2

a—Net assets at the beginning of each year are based upon the excess of total balance sheet assets over liabilities; the amounts at which assets are carried on the books are far below present-day values. b—Profit margins computed for all companies publishing sales or gross income figures, which represent over nine-tenths of total number of reporting companies, excluding the finance groups; includes income from investments and other sources as well as from sales. c—Net income is reported before depletion charges in some cases. d—Due to the large proportion of capital investment in the form of funded debt, rate of return on total property investment would be lower than that shown on net assets only. e—Figures represent in most cases operating earnings only, excluding capital gains or losses on investments. † Increases or decreases of over 100% not computed. D—Deficit.



Average Percentage Profit Margin on Sales and Rate of Return on Net Assets of Leading Manufacturing Corporations.

than in earlier years of active business, whereas the profit margins on sales have held around the former level, may be attributed largely to two factors. One is the recent increase in rate of capital turnover, as measured by the ratio of sales to net assets. This is due in part to the price inflation of dollar sales relative to capital, and in part to capacity or near-capacity operations, which result in highly efficient use of production facilities.

The second factor, already referred to, is that earnings are counted in current dollars, whereas book net assets, upon which the rate of return is computed, are based in part on costs of plant and equipment acquired years ago at far below present-day replacement costs. The value of all land, buildings, equipment, mineral resources, etc., owned by American manufacturing corporations, and as carried on the books after deducting the reserves for depreciation, depletion, and amortization, now represents approximately one-third of their reported total assets. On that portion a considerable disparity persists between book and actual values, despite the record-breaking investments which have been made by industry for the expansion and modernization of facilities since 1945 and which have reflected the rising level of costs.

Price inflation since the war has distorted the reported earnings of industry in a number of other ways which are revealed by an analysis of the statements. Charges against income for the depreciation of plant and equipment are usually based upon historical costs and therefore are much below the actual costs of replacement. Rising prices at which goods are turned over have created billions of dollars in inventory profits that are a nonrecurring and frequently misleading source of earnings.

A great many statements for 1951 that indicated large earnings, and, after paying out only moderate dividends, a substantial portion retained in the business, at the same time show a serious impairment of the cash position. This is because all of the surplus earnings and much more was absorbed by the heavy outlays made on plant and by the liquid assets tied up in swollen inventories, resulting in substantial increases of both short and long-term debt. It is a case of being apparently prosperous, yet very short of money.

Numerous companies which reported near-record earnings in 1951 have nevertheless been forced to curtail their dividends since the beginning of this year, presumably in order to conserve cash and to avoid further bank borrowing for taxes or other purposes. According to the compilations by the New York World-Telegram and Sun of the number of public dividend declarations, the following unfavorable shifts have occurred during the first quarter of 1952 as compared with a year ago:

	First Quarter 1951	1952
Increased dividends	199	91
Extra dividends	288	181
Reduced dividends	6	34
Omitted dividends	9	40

Trends in Other Lines

In the retail and wholesale trade groups, 197 reporting companies had sales aggregating $22 billion, up 14 per cent from the previous year, but a fall in net income of 17 per cent. The net profit margin was squeezed by the pressure of rising costs and taxes against fixed OPS ceilings on selling prices from an average of 3.8 cents to 2.7 cents per sales dollar. For the 23 leading food chains reporting, the average net profit last year was but 1.1 cents per sales dollar.

Class 1 railroad systems had an increase of 10 per cent in gross revenues but a decrease of 12 per cent in net income. The air transport group had a gain of 24 per cent in gross and an increase of 39 per cent in net.

Among the public utility systems supplying electric, gas, telephone, and other services there were moderate fluctuations, but their combined net income was little changed. It represented, therefore, a lower rate of return on their increased net assets, and a narrower profit margin on their increased gross revenues.

Patman Committee Hearings

The Congressional subcommittee, headed by Congressman Wright Patman of Texas, investigating "Monetary Policy and the Management of the Public Debt," began a three-weeks' schedule of public hearings on March 10. These hearings, along with voluminous other materials gathered by Mr. Patman and his staff, cover a

wide variety of ideas and topics. But what is perhaps most remarkable is the almost universal acceptance of the principle that, if the dollar is to hold its purchasing power, there must be freedom of movement in the market for government securities, discretion in Federal Reserve purchases of government securities, variations in the cost of borrowed money to the Government, and flexibility in the management of the public debt. With some notable exceptions, most of the statements filed with the subcommittee reveal deep-seated concern over the wastage in the value of the dollar and the inflationary consequences of using the Federal Reserve Banks to support government bond prices at artificial levels. Some of the documents and testimony will deserve lasting places in the literature as statements of sound money principles, the need for responsible independence in Federal Reserve Bank operations, and the risks in turning the powers of money-issue over to the Executive branch of the Government.

The inquiry reflects a wide swing of opinion, away from the early postwar views that government bond prices just *had* to be pegged and that severe taxation, supplemented by administrative control devices of one kind or another, could be sufficient to protect the buying power of the dollar against the threat of heavy government expenditures and progressive credit inflation. Indeed, the testimony represents the first time in the modern history of the United States that predominant opinion, among concerned government officials, economists, business men and bankers, has rallied to the defense of free market principles in money and credit as an essential to economic stability.

As reported in the November issue of this Letter, the present inquiry had its beginnings in April 1951, when Senator Joseph C. O'Mahoney of Wyoming, Chairman of the Congressional Joint Committee on the Economic Report, appointed a special Subcommittee on General Credit Control and Debt Management, headed by Congressman Patman. The other members of the subcommittee are Senator Paul H. Douglas of Illinois, who headed a similar inquiry two years ago; Senator Ralph E. Flanders of Vermont; Congressman Richard Bolling of Missouri and Congressman Jesse P. Wolcott of Michigan.

Background Materials

Just before the hearings began the subcommittee published two volumes of material, 1300 pages in all, mostly replies to questionnaires which had been sent out by Congressman Patman last October. In view of the short time allowed respondents, and the voluminous information requested, the quality of the answers is surprisingly high. The material supplied by the Chairman of the Federal Reserve Board (437 pages) and by the Secretary of the Treasury (195 pages) make up the bulk of one volume. The second volume contains answers by Federal Reserve Bank presidents (many of them submitted jointly), the President's Council of Economic Advisers, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the Administrator of the Reconstruction Finance Corporation. Also included in the second volume are excerpts from answers to questionnaires sent to State bank supervisors, economists, bankers, life insurance company executives, and dealers in government securities. About 400 replies were received from some 1,200 persons outside the Federal Government to whom questionnaires were sent.

The immediate occasion for the Patman inquiry was the "Accord" reached by the Treasury and Federal Reserve authorities, after a hot controversy, in March, 1951. It was under the Accord, it will be recalled, that the Treasury acquiesced in a withdrawal of Federal Reserve bids for government bonds in the open market, the object being to check inflation of money and credit. Previously, the Federal Reserve Banks had been buying government bonds to peg their prices at or above par, and it was the holder of government bonds, rather than the Federal Reserve, who decided how many government securities the latter would buy. After the Accord was reached the Federal Reserve Banks regained a discretionary control over their purchases and sales of government securities, and government bonds declined as much as 4⅜ points below par.

The Patman inquiry was launched a month after the Accord was announced and on the assumption that it was not working out to full satisfaction of the parties concerned. In June Congressman Patman made clear his own disapproval of the Accord when he proposed a resolution in the House of Representatives which would have required the Federal Reserve Banks to peg bond prices at par.

Satisfaction With the Accord

Against this background, the responses by the officials concerned were awaited with great interest. In their replies to questionnaires, and also in the hearings, Secretary of the Treasury Snyder and Federal Reserve Board Chairman Martin stated their satisfaction with their working relationships. Secretary Snyder, while favoring a "stable market" for government bonds, admit-

ted that Federal Reserve buying of government bonds "contributes in a degree" to inflation and disavowed any "doctrinaire views on holding interest rates generally over a long period of time at any one point." Chairman Martin, in his testimony, admitted that, "on balance, the System, through its support of government security prices, accentuated postwar inflationary pressures" and stressed the need for "flexible credit and monetary policy, together with flexible debt management policy and an adequate fiscal program" as essential to economic stability.

Neither official, nor the assembled documents lent support to the idea that pegs should be restored in the government bond market. Indeed, the principle was often emphasized, in the broad mass of testimony, that the Federal Reserve must exercise discretion in their purchases of government securities, and that the necessary support to the public credit should come from sound financial policies combined with the offer of rates of interest competitively attractive in the free market. Mr. W. L. Hemingway of the Mercantile Trust Company in St. Louis, representing the American Bankers Association at the hearings, summarized the problem crisply:

> In the final analysis, the Treasury should recognize that it must go into the market as a borrower, and not as a printer of money through the debt-creation mechanism. This means that it is dependent upon prevailing and prospective conditions of supply and demand for funds in a money market that is geared to a sound credit policy. At the same time, the Federal Reserve must recognize the needs of the Treasury in its refunding and new borrowing operations. Admittedly, this is not an easy process, but with men of good will and experience the result achieved thru proper cooperation should be constructive.

The Inflation "Lull"

Senator Douglas, who headed the inquiry two years ago that produced the well-known Douglas report, asked most of the questions of the principal witnesses at the hearings. As then, Senator Douglas displayed apprehensions that differences between the two agencies, under the mantle of "cooperation", tend to be settled too often in terms of the Federal Reserve's pumping out more money to put over new issues of Treasury securities. At one point he asked Secretary Snyder the rhetorical question: "Has the United States come to such a pass that the securities need artificial support?"

Senator Douglas probed the views of many witnesses on the part the bond market unpegging played in the "lull" of inflationary pressures that has developed since March 1951. Leon Keyserling, Chairman of the Council of Economic Advisers, questioned along these lines, considered the unpegging a relatively minor factor and was inclined to attribute the relative price stability experienced since March 1951, more to the increase in production, the slower than contemplated defense build-up, tax increases, individual savings, price and wage stabilization, and the materials allocation machinery. Other witnesses generally assigned to the unpegging a higher order of influence. Answers by bankers and life insurance company executives confirmed that lending policies were tightened after the drop in the bond market and the virtually simultaneous launching of the Voluntary Credit Restraint Program.

"Insulating" the Public Debt

The questionnaires invited expressions of view on three inter-related subjects: (1) possibilities of devising new kinds of reserve requirements to tie up commercial bank funds in government securities and to curtail their ability to lend to private borrowers, States and municipalities; (2) possibilities of "insulating" the Federal debt when the overall credit supply is being restricted; and (3) possibilities of *compelling* financial institutions, corporations and individuals to buy government securities. These questions precipitated a wide variety of answers among economists, although it did not escape notice among them that the questions not only were interrelated but rested on the common assumption that the Federal Government could not pay going rates in a free market for the money it wants to borrow. This is a dubious assumption for a country that prides itself on being the strongest capitalist nation on earth, that carries on its business in competitive markets, and that enjoys the richest flow of tax revenues anywhere.

One eloquent answer on the question of "insulating" the public debt from the market was provided by Allan B. Kline, President of the American Farm Bureau Federation, who wrote: "It is totally impossible". Certainly this is correct in a fundamental sense. The compulsory purchase of government securities is more a tax than anything else, and the imposition of requirements on the banks to hold "supplementary reserves" in government securities contains the element of a discriminatory tax. If the Government wants to tap the loan market, and to attract funds people are free to lend or not to lend, it has to offer a competitively attractive rate. This may be harder than forcing securities on somebody. But opening up channels for forced loans is no way to put a check on excessive government expenditures; applied to banks

it affords the opportunity of financing deficits with inflation of the money supply.

At the hearings, Federal Reserve Board Chairman Martin revealed that he has recently veered away from the supplementary reserve requirement proposal, advocated by the Board 1946-48:

> I certainly do not want it to appear that the Federal and the Treasury are using supplementary reserves as a device to compel the banks to finance the deficit because we want to finance this deficit in a non-inflationary way by attracting the savings of non-bank investors into Government securities.

The Federal Reserve Bank presidents, called upon to evaluate the merits of supplementary reserves, summarized their view briefly with the statement:

> . . . if the Federal Reserve System has effective control over the supply of reserves under a flexible open-market policy, a supplementary reserve is unnecessary; without such control, a supplementary reserve would be ineffective.

In a memorandum issued by the President in February 1951, it was suggested that, in order to "maintain stability in the government security market and confidence in the public credit of the United States", and at the same time curb private loan expansion, he might invoke certain emergency powers, vested in 1917 and 1933 legislation. These, if still valid, seemingly would permit licensing by the Treasury, or by agents of the Treasury, of individual credit transactions. The Federal Reserve Bank presidents, asked in the questionnaire to comment on the use of such powers, reviewed the enormous difficulties of administration and stated their "repugnance" to regulating credit transactions on a case-by-case basis: "We do not believe that the Federal Reserve System or a government agency could establish and administer standards which presumably would be substituted for the judgment of lenders in individual transactions."

The Issue of Independence

The issue of independence of the Federal Reserve System figured largely in the inquiry. This was natural since it had been precipitated, in effect, by the refusal of the Federal Reserve authorities to peg bond prices as desired by the Executive. Secretary of the Treasury Snyder favored setting up a "top-level advisory group to the President on broad questions of monetary and fiscal policies." Such a group, which he thought might be composed of the Secretary of the Treasury, Chairman of the Federal Reserve Board, Director of the Budget, Chairman of the Council of Economic Advisors, and Chairman of the Securities and Exchange Commission, would have periodic meetings designed to iron out differences of opinion and to carry on informal discussions with the President on broad questions of monetary and fiscal policy. Secretary Snyder did not suggest, however, that the Federal Reserve should give up its legally independent status as an instrumentality of the Congress.

Senator Douglas pointed out how a proposal of the sort advanced by the Secretary might provide "an opportunity to twist the arm" of the Federal Reserve, and Chairman Martin, testifying the following day, confessed to "some uneasiness" as he analyzed it and stressed the fact that the Federal Reserve has a "judicial function" to perform. "It is the judicial judgment of the Federal Reserve with respect to its particular province which warrants our independence".

Chairman Martin's concept of the Federal Reserve System accords with the traditional doctrine of the separation of powers which underlies our democratic institutions:

> The System is a unique concept, an ingenious merging of public and private interests in a characteristically democratic institution. The doctrine of the separation of powers, as Mr. Justice Brandeis once pointed out, was adopted "not to promote efficiency but to preclude the exercise of arbitrary power." The purpose was "not to avoid friction, but by means of the inevitable friction incident to the distribution of the Government powers among three departments, to save the people from autocracy." Doubtless this reserve banking mechanism could be more efficiently devised or differently organized in the Governmental structure but it would be at the cost, I think, of something far more important. . .

Mr. Malcolm Bryan, President of the Federal Reserve Bank of Atlanta, likewise directed the attention of the committee to fundamentals and went on to say:

> . . . If I be reminded that practically all the countries of the world have made their central banks responsible to the borrowing, executive agents of government and that we in the United States are not quite in fashion, then I can only reply that the monetary chaos exhibited in many countries of the post-war world is a sufficient admonition to us to think in the light of things eternal rather than in the light of the most recent high style.

The Fight for the Pound

Few budgets in Britain's history have been awaited with greater anxiety and hope than the first budget of the Conservative Government presented to the House of Commons on March 11. The tasks confronting the new Chancellor of the Exchequer, Mr. R. A. Butler, and the problems to be solved, were known to include halting and reversing the dangerous drain on Britain's monetary reserves, fitting the rearmament program into the country's economy, and checking internal inflation. The new budget was expected

to introduce measures to relieve the overload on Britain's economy, give it more flexibility, and inject incentive by reducing the tax burden, restoring the price system, and, in general, making more room for private enterprise.

"We mean to try and take a new line to get out of our difficulties," the Chancellor declared, "the line of facing facts, of giving help where it is needed and rewards for more work done . . . Solvency, security, duty and incentives are our themes . . . Restriction and austerity are not enough . . . A true and lasting solution for our present troubles can be found only through harder work and increased output." He warned that if things were allowed to drift, "We in this island would, before the end of the year, have found ourselves unable to secure either our daily bread or the raw materials on which both employment and production depend."

In short, only by demonstrating its ability to live within its means can Britain restore confidence in the pound sterling and retain its position as an international banker and trader. The growing restiveness in the overseas sterling area last fall over the inability to realize on the sterling assets to purchase much needed capital goods from hard currency areas was a hint that convertibility of the pound sterling could not be postponed indefinitely.

Britain's gap in current account payments with the non-sterling world in 1951 was in the region of £700 million; a surplus in payments with the sterling area reduced the overall gap to £516 million. Most of this deficit occurred during the latter half of the year when the deficit with the non-sterling world was running at an annual rate of £1,200 million.

The new budget represented the third and crucial instalment of the Conservative Government's emergency program for rectifying this imbalance. The first instalment announced early in November soon after the new Government's installation, embraced sharp cuts in imports and tourist allowances. Suspension of nonessential building other than housing was decreed to lessen inflationary pressures and release materials for defense and export industries. At the same time the long inoperative technique of orthodox monetary policy was revived. The Bank of England discount rate was lifted from 2 to 2½ per cent, and other measures taken to tighten the money market.

The second instalment of the emergency measures came at the end of January, following the conference of Commonwealth finance ministers in London. To halt the drain on gold and dollar reserves, imports and tourist allowances were slashed further. Deliveries of consumer durable goods to the home market were cut drastically. Government civil service was to be reduced and other economies instituted. Not even the National Health Service – generally regarded as sacred ground – escaped untouched.

Further Steps to Reduce Balance of Payments Gap

Despite these measures – all of which take time to operate – international confidence in sterling remained low and the dangerous drain on reserves continued. As the Chancellor revealed in his budget speech, the average weekly loss of reserves during January and February rose to $63 million, as against an average of $46 million during the third quarter of 1951 and $58 million in the fourth quarter. "The drain was all the greater," the Chancellor explained.

> because the position of the other sterling area countries was also getting worse. The prices of their main exports – rubber, tin, wool and so on – which had been so high in the winter of 1950-51 were falling to more normal levels, while their imports – the result of the earlier rise in incomes – were increasing. As a result, most of them moved into substantial deficit, not only with ourselves, but with the non-sterling world.

By the end of February the gold and dollar reserves were $1,770 million, down nearly $2,100 million from the peak, and back again near the levels reached during the previous postwar crisis years, 1947 and 1949.

While they could undoubtedly count, the Chancellor said, on a considerable reduction in the rate of gold and dollar outflow once the emergency actions had time to operate, this was not enough. He therefore proposed additional reductions in imports, bringing the total import cuts to £600 million annually. This was expected to bring actual expenditures for imports in 1952 to £3,150 million, more than £300 million less than in 1951. Since some £175 million is to be saved by curtailing stockpiling, the imports to be diverted from all other purposes come to about £150 million.

On the other side of the balance sheet, the Chancellor was counting on picking up £200-£250 million from improvement in invisibles and in terms of trade. In addition he was setting a target of an increase of about £50 million in the volume of exports. "Some may think this is a small figure," said the Chancellor,

> but we must remember that our exports of consumer goods to the sterling area will probably decline. Australia has just decided on a sharp cut in imports from us, particularly of consumer goods, as a consequence of the combined plan for bringing the sterling area into balance.

This will mean, Mr. Butler stated, selling very much more than before in non-sterling area

countries, where the strongest demand is for capital goods — unfortunately, just the kind it will be hardest for Britain to spare.

Diversion of Resources

What all this signifies asserted Mr. Butler, is a "really major diversion of effort, if we are to survive and pay our way."

Counting the planned curtailment in imports, and increase in exports, the Chancellor figured at some £200 million the additional resources that would have to be drawn from other uses internally to meet the balance of payments crisis. To this he added £200 million to allow for the additional draft in resources caused by the defense program, making £400 million in all.

To meet this, Mr. Butler expects, first, that £250 million, or about the same amount as last year, will come from additional production. He anticipates, second, that £50 million will be released by economies in the Government, and, third, that civil investment will fall by no less than £100 million.

To accomplish the diversion of resources from investment to export and to show the world that "we are serious in our determination to leave no weapon unused to promote exports and defend the pound," Mr. Butler relied, among other things, on the Bank rate. "One of the surest ways to make sterling stronger," he asserted, "is to make it scarcer, and that is what we intend to do."

By raising the official discount rate from 2½ to 4 per cent, by introducing stiffer conditions for lending and by streamlining raw material allocation, the Chancellor hopes for "a marked reduction in civilian investments, particularly in plant and machinery and in stock (inventories)."

Mr. Butler rejected the idea of making any cuts in consumption on the ground that (1) the savings in resources described are those which will help most in increasing exports, and (2) many industries producing consumer goods are already facing slack demand at home and abroad.

General Budget Strategy

On the question of general budget strategy, Mr. Butler starts with the key proposition that "if the home consumer is to have no more of our resources than last year, we must see to it that his purchasing power as a whole is no more than sufficient for this purpose."

Ordinary expenditures for 1952-53 were expected to reach £4,240 million, up £82 million from the revised estimates for 1951-52. Revenues at current rates were expected to bring £4,778 million, an increase of £338 million. This means an indicated "above the line" surplus (excluding capital expenditures) of £538 million.

Allowing for the rise in consumer goods prices, and for some increases in incomes, Mr. Butler decided to leave the budget surplus broadly where it was. The money which people would have to spend in the coming year would, he judged, be just about enough to pay for the goods likely to be available.

But, he went on to state, within this general framework of a substantially unchanged budget surplus, there was urgent need for many adjustments. In the first place, the budget was much too big; and, as he pointed out in words that might well be taken to heart in other quarters, "high government expenditure accompanied by high taxation itself has an inflationary effect." If the budget is to fulfil its main function — to restore confidence in the pound — it must, he added, further reduce government expenditure and make a start in reducing taxation.

Second, there must be some reallocation of burdens, giving recognition to incentives, so that "we go into action inspired by the sense that if we work harder we can earn more."

Reallocating the Burdens

To bring back "a sense of reality to our personal as well as our national accounts," the Chancellor proposed a reduction in food subsidies by nearly 40 per cent, from £410 million to £250 million, on the score that

> the subsidies conceal from the consumer the real cost of what we have to pay in exports for the foods we import. As a result people tend to spend a large part of their incomes on the non-essentials of life.

The reduction of subsidies will make the rationed food 1s 6d (about 21 cents) a week dearer per head. However, almost half of the amount saved by subsidies is to be handed back to those most in need by increasing the family allowances and old age and widows' pensions, and by changes in the income tax designed to have incentive effect, particularly in the lower and middle income brackets. These tax changes include increasing personal exemptions and lifting the percentage of earned income which, up to a ceiling, is not liable to tax. All taxpayers will enjoy some relief, but the most significant effect will be that pay for overtime work will normally not be liable to tax at the full standard rate.

While former rates of corporation taxes were reduced, both for distributed and undistributed profits, a new "excess profit levy" will be charged during the duration of the emergency at the rate of 30 per cent on profits above the average

of the years 1947-49. Other budget changes include an increase in the duty on gasoline.

Summarizing the net effect on the budget position of all this reshuffling of revenue and expenditure results, Mr. Butler stated, in a final surplus "above the line" of about £510 million – only slightly less than at the outset. It will cover also by a small margin the Government's capital needs carried "below the line" in the Exchequer accounting.

Reactions to the Budget

The budget has been attacked from the Left as "class legislation" designed to help those who have at the expense of those who have not. Such attacks, however, have had something of a hollow ring in view of the ingenious manner in which the reduction in food subsidies has been balanced off for the middle and lower income groups by the increased pensions and by the concessions in the income tax.

In the financial markets, the fall in gilt edge issues has represented a conventional response to the higher Bank rate, while the equity market has been depressed both by the new Excess Profits Levy and by the bearish tone of the Chancellor's remarks concerning the outlook for many consumer goods industries facing slack demand at home and abroad. On the other hand, the improvement in sterling has been evidence of a favorable reception of the budget abroad, and since bolstering the pound is the primary objective, this is of very great importance.

It remains of course to be seen to what extent the improvement in sterling can be held. Both in conception and execution, the adequacy of the program has yet to stand the test of experience. In projecting estimates in such areas as national output, balance of international payments, budgetary income and outgo, and consumer spending and saving, there is always wide room for error, and there are those who feel that Mr. Butler has drawn his margin of safety pretty fine.

The London Economist, for example, criticizes Mr. Butler in that –

> he has taken a sanguine view of the probable increase in the total output of the country (£250 million over 1950-51) . . . he seems to have underrated the volume of resources that will have to be shifted if the defense and export objectives are to be attained (£400 million).

The Economist also thinks that Mr. Butler put the prospective gain from invisible exports too high, and that he exaggerated the extent to which imports can be cut without reacting adversely upon exports. Like a number of other commentators, the Economist questions whether the Chancellor has not been too soft in deciding against steps to reduce consumption, suggesting that he "is relying heavily on rising prices to limit consumption and allowing very little for the contrary effect of rising wage rates."

For such reasons, the Economist believes Mr. Butler would have been wiser to have reinforced his budgetary surplus by another £200 to £300 million.

The decision to impose an Excess Profits Levy, to which the Conservatives were committed in their election campaign, constitutes the outstanding departure from the principle of fostering incentive and providing reward for extra effort. The levy has been denounced by the Federation of British Industries as "destructive of enterprise", and bound to penalize efforts to increase exports over the standard years (1947-1949). Its view, widely shared outside Labor circles, is that the measure will not only discourage enterprise and encourage waste and extravagance, but will increase industry's already serious difficulties in maintaining capital, upon which the long-range efficiency and productivity of British industry also depends.

Collective Responsibility of the SterlingArea

The overseas sterling area countries likewise have a responsibility for the state of the central reserves. They too must live within their means. The Commonwealth finance ministers recognized this, and agreed at the January meeting that "corrective measures should be taken as soon as possible in order to relieve the current pressure on the resources of the area."

They also agreed that the recovery of the sterling area will not be complete

> until the conditions have been created in which sterling can become and remain convertible . . . Accordingly it is our definite objective to make sterling convertible and to keep it so . . .

But if confidence in the pound sterling is to be restored, Great Britain, as the banker of the sterling area, must lead in bringing its own international payments into balance. The new British Finance Minister voiced his Government's determination to forge ahead to that objective in closing his speech with the following exhortation to the British people:

> We must now set forth, braced and resolute, to show the world that we shall regain our solvency and with it our national greatness.